

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. [Redacted]
[Redacted])	
)	DECISION
Petitioners.)	
_____)	

[Redacted](petitioners) protest the Notice of Deficiency Determination issued by the auditor for the Idaho State Tax Commission (Commission) dated November 18, 2004. The notice of deficiency allowed a refund of income tax and related interest for 1999 in the amount of \$1,135 and denied a requested refund of income tax for 2000 in the amount of \$8,812 plus related interest.

The issues involved in this matter are as follows:

1. Whether the petitioners should be allowed a deduction with regard to their purchase of notes (and if so, the nature and amount of such) owed by [Redacted]. (hereinafter [Redacted]), a limited partnership.
2. Whether the petitioners should be allowed a deduction for the unpaid expenses of [Redacted].
3. Whether the petitioners should be allowed a deduction for their assumption of a note owed by [Redacted] to its general partner, [Redacted]. (hereinafter [Redacted]), an S corporation.
4. Whether the petitioners should be allowed a deduction for personal loans to [Redacted] in the total amount of \$220,000.
5. Whether the petitioners should be allowed a deduction for their payment pursuant to a guarantee of a loan made to [Redacted].

The petitioners held a 60 percent interest in [Redacted]. [Redacted] owned a 25 percent interest in [Redacted]. [Redacted] was the general partner in [Redacted]. The petitioners also directly held a 16 percent limited partnership interest in [Redacted].

NOTES OF [Redacted]

It appears that [Redacted] ceased operation some time in the latter part of 1999. Approximately two years earlier, [Redacted] had borrowed funds from several individuals. These loans were not repaid when [Redacted] ceased operations. In 2000, Mr. [Redacted] purchased these debts from the lenders at or near full value. The petitioners wish to deduct the amounts for which they purchased the worthless notes.

The notes were all similar. The notes were signed as follows:

[Redacted] The petitioners wish to deduct the amounts paid in relation to the notes here in question as basis in [Redacted]. As a general matter, a partner's basis is increased for a partner's share of partnership debts. Treasury Regulation 1.752-2 states, in part:

Partner's share of recourse liabilities.

- (a) In general. A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.
- (b) Obligation to make a payment.
 - (1) In general. Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

For such payments to be deductible, the partner (in this case the petitioners), must have been liable to make the payment. The petitioners held a direct interest in [Redacted] as limited partners.

Limited partners are generally liable for the partnership debts only to the extent of their holdings in the partnership and are not liable for any further contributions for the debts of the partnership. Idaho Code § 53-219. Therefore, it appears that their holding of the limited partnership interest did not cause them to be liable for the notes which the petitioners purchased. Therefore, no deduction is allowed with regard to their holding the limited partnership interest.

The petitioners also held an interest in [Redacted] an S corporation, which was the general partner in [Redacted]. Usually, a general partner is liable for the debts of the partnership. However, a shareholder in a corporation is generally not liable for more than his investment in the corporation. Ross v. Coleman Co., 114 Idaho 817, 831 (1988). We see nothing in the record to indicate that the resolution of this matter should not follow this general rule. Therefore, no deduction is allowed with regard to the petitioners holding the interest in the corporation.

In reviewing the language of the notes above, the Commission finds that the petitioners have not established that they were personally liable on the notes. The note above lacks any semblance of invoking personal liability on the petitioners.

THE EXPENSES OF [Redacted] The petitioners seek deductions for “expenses paid in behalf of Company” in the total amount of \$78,278.71. The petitioners submitted canceled checks to support their position. It appears that some of these expenses were those of [Redacted]. For many of the expenditures, it is entirely unclear for which entity they were paid or what the claimed business purpose might have been. The expenses which appear to have been paid for [Redacted] appear to have been paid after the termination of the activity of [Redacted].

No grounds have been set out as to why the petitioners, either as limited partners in the partnership or as shareholders in [Redacted] (a corporation), the general partner in [Redacted], would be personally liable for these expenses. Generally, a partner may not deduct the expenses of

the partnership. Johnson v. Commissioner, T. C. Memo 1984-598. It appears that the petitioners gratuitously paid the expenses of [Redacted]. Therefore, the expenses are those of the partnership and not those of the petitioners. Accordingly, these deductions are denied.

ASSUMPTION OF [Redacted] NOTE

Mr. [Redacted] contends that he assumed the debt resulting from the following promissory note:

PROMISSORY NOTE

\$131,081.47

March 5, 1998

[Redacted], an Idaho Partnership, D.B.A. [Redacted] Company, located at [Redacted], this 25th Day of March, 1998, for value received does promise to pay to the order of [Redacted], an Idaho Corporation, located at [Redacted], the sum of One-Hundred-Thirty-One-Thousand-Eighty-One-And-47/100-Dollars (\$131,081.47) in lawful money of the United State of America at [Redacted], with interest thereon, in like money at the rate of twelve percent (12%) per annum, payable monthly with payments of principle and interest in the amount of \$2,500.00 beginning April 25th, 1998 and continuing on the 25th of each subsequent month until March 25th, 1999 when the note is due and payment of accrued interest and principal shall be paid. Payments received more than ten days after the due date are subject to a late fee of \$75.00. Payments received shall be credited first to late fees, then interest accrued, then principal. If not paid at maturity and this note is placed with an attorney for collection, or if suit be instituted for its collection, the prevailing party shall be entitled to recover reasonable costs including attorney's fees from the non-prevailing party. Security for this note shall be all assets of [Redacted]. The undersigned representative of the General Partner does hereby acknowledge that the General Partner has approved this action on behalf of [Redacted], at a meeting of said body, and further offers personal guarantee to the noteholder that should [Redacted] be unable or unwilling to perform according to the terms and conditions of this note, the guarantors shall make all required payments required under the conditions of this promissory note. There shall be no pre-payment penalty.

[Redacted]
President of [Redacted]The General Partner

DUE MARCH 25, 1999

The verbiage in this note is somewhat puzzling. The intent as to the personal guarantee is unclear. What is clear is that the only parties to the note are the partnership ([Redacted]) and the S

corporation ([Redacted]). Mr. [Redacted] did not sign the document in his personal capacity. Therefore, it appears clear that any personal guarantee cannot be attributed to one who did not sign the document. It is only signed by Mr. [Redacted] as an officer of [Redacted], the general partner of [Redacted]. Therefore, the Commission finds that the petitioners have failed to carry their burden with regard to any personal liability arising from this note. Absent a showing of personal liability by the petitioners, the Commission finds that no deduction is available.

LOANS TO [Redacted]

The petitioners seek to have included in their basis in [Redacted]¹ amounts which total \$220,000. They contend that they loaned amounts with a sum of \$220,000 between January 29, 1996 and January 15, 1998 to [Redacted]. In support of this claim, the petitioners submitted a schedule of these amounts. Most of these amounts were also supported by promissory notes. The notes were signed by “[Redacted], an Idaho partnership.” One of these alleged advances (dated July 8, 1996 in the amount of \$15,000) was apparently made by [Redacted], a partnership in which the petitioners held an interest. Two of these alleged advances, each in the amount of \$10,000, one dated September 17, 1996, the other October 4, 1996, were not supported by any additional documentation. Another alleged advance in the amount of \$5,000 was supported only by an unsigned handwritten piece of paper. The petitioners did not supply copies of the checks (or other means of payment) for most of these amounts. The lone exception was for an amount of \$10,000 on March 11, 1996. [Redacted] purchased a cashier’s check in that amount payable to [Redacted]. It was noted that it was for [Redacted] (which was a name under which [Redacted] operated).

¹ A letter from the petitioners’ representative indicates that this amount relates to [Redacted], but it is apparent from the accompanying information submitted that it should be attributed to [Redacted].

If these amounts were advanced and not repaid, it would increase the amount of the petitioners' investment in [Redacted]. If or when the entity was terminated, such amounts would be considered in computing the petitioners' gain or loss from such termination.

Some questions remain unanswered. Was [Redacted] dissolved? If so, when? [Redacted] did not file Idaho income tax returns. From the information in the file, it appears that all of [Redacted]'s activity was in the state of [Redacted]. Therefore, [REDACTED] was not required to file Idaho income tax returns.

From information in the file, it appears that at the beginning of 2000, there were still substantial assets remaining in the partnership. What became of the assets? Were they distributed to the partners? Since the petitioners made good several of the loans to [Redacted], were the assets distributed to them? While it would appear that the petitioners have or will have a loss from the disposition of their interest (as limited partners) in [Redacted], there is insufficient information in the file to enable the Commission to compute the amount of such loss or to determine the taxable year in which such a loss should be recognized. Therefore, no loss with regard to the disposition of the petitioners' interest in [Redacted] is allowed.

GUARANTEE OF [Redacted] NOTE

In January of 1998, [Redacted] formed a new corporation by the name of [Redacted] (hereinafter [Redacted]). Initially, [Redacted] held 60% of the stock of this corporation and [Redacted] held the remaining 40% of the stock. On January 1, 1999, [Redacted] agreed to sell his stock in [Redacted] to [Redacted] for \$163,000. Of the purchase price, \$53,000 was paid in cash² and the remaining \$110,000 was in the form of a promissory note amortized over ten years. Early in 2001, [Redacted] defaulted on the promissory note. In addition to the default on this

² Neither this \$53,000 nor the payments on the note were reflected on the petitioners' income tax return. After further investigation, this may need to be adjusted.

note, [Redacted] defaulted on a loan from [Redacted]. This note had been guaranteed by [Redacted]. [Redacted] filed a chapter 7 no asset bankruptcy in October, 2001. Mr. [Redacted] was called upon to make good his guarantee. On or about November 1, 2001, Mr. [Redacted] borrowed from Idaho Independent Bank \$98,205.75 with which he paid the balance due to [Redacted]. The Commission finds that the petitioners are entitled to business bad debt deduction for \$98,205.75 in 2001.

WHEREFORE, the Notice of Deficiency Determination dated November 18, 2004, is hereby MODIFIED, and as so modified is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners receive a refund of the following tax and interest (calculated to December 15, 2005):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
1999	\$1,794	\$427	\$2,221
2000	3,289	780	<u>4,069</u>
		TOTAL REFUND	<u>\$6,290</u>

An explanation of taxpayers' right to appeal this decision is enclosed.

DATED this _____ day of _____, 2005.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2005, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in envelopes addressed to:

[Redacted]

[Redacted]